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Item 35 of the provisional agenda*
THE SITUATION IN THE MIDDLE EAST

SECURITY COUNCIL
Forty-fifth year

Letter dated 3 August 1990 from the Chargé d'affaires a.i.
of the Permanent Mission of the German Democratic Republic
to the United Nations addressed to the Secretary-General

I have the honour to transmit herewith a statement issued on 2 August 1990 by the Foreign Minister of the German Democratic Republic (see annex).

I should be grateful if you would arrange to have the present letter and its annex circulated as an official document of the General Assembly, under item 35 of the provisional agenda, and of the Security Council.

(Signed) Dr. Kurt KUTSCHAN
Envoy Extraordinary and
Minister Plenipotentiary
Chargé d'affaires a.i.

* A/45/150 and Corr.1.

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English
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ANNEX

Statement issued on 2 August 1990 by the Minister for
Foreign Affairs of the German Democratic Republic on
the Iraqi invasion of Kuwait

German Democratic Republic Foreign Minister Meckel is deeply concerned at the new aggravation of the situation in the Persian Gulf. He condemns the use of military force and calls upon Iraq immediately to withdraw its troops from Kuwaiti territory. Everything should be done to prevent an extension of the conflict. International disputes should, in the view of the Foreign Minister, be settled by way of negotiations respecting the sovereignty and territorial integrity.

The German Democratic Republic supports all initiatives that promote a political settlement of the conflict.



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THE SITUATION IN AFGHANISTAN AND ITS IMPLICATIONS FOR
INTERNATIONAL PEACE AND SECURITY

OFFICE OF THE UNITED NATIONS HIGH COMMISSIONER FOR REFUGEES

PEACEFUL SETTLEMENT OF DISPUTES BETWEEN STATES

Letter dated 2 August 1990 from the Permanent Representative
of Afghanistan to the United Nations addressed to the
Secretary-General

I have the honour to transmit to you a statement issued by the Government of the Republic of Afghanistan addressed to you (see annex).

I have further the honour to request that the text of the present letter and its annex be circulated as an official document of the General Assembly, under items 29, 110 and 144 of the provisional agenda.

(Signed) Noor Ahmad NOOR
Ambassador
Permanent Representative

* A/45/150 and Corr.1.

ANNEX

Statement issued on 22 July 1990 by the Government of Afghanistan

In line with the policy of national reconciliation as the only alternative to war under the prevailing conditions in the country, the State of the Republic of Afghanistan has taken all possible steps towards establishment of peace, revival of Afghanistan and voluntary return of the refugees. At present, when the unfeasibility of the military solution to the country's problem has been shown, we are witness to immense changes in the country's political atmosphere marked with a rise in the tendency towards peace, understanding and dialogue among various conflicting parties and among the public opinion of the country.

Currently, the need for a fraternal and constructive intra-Afghan dialogue and understanding is felt more than ever before in order to achieve the earliest political settlement of the issues.

The Government of the Republic of Afghanistan holds the view that one of the leading aspects of the political settlement is the return of the refugees who are living a tragic life in foreign countries. Hence, overcoming this question requires manifold steps and co-operation on the part of all the Afghan warring forces, the involved countries, particularly Pakistan, in accordance with the fourth instrument of the Geneva Agreements dealing with the voluntary return of the Afghan refugees, as well as on the part of the United Nations and other peace-advocating international quarters.

The State of the Republic of Afghanistan welcomes the recent measures of the United Nations High Commissioner for Refugees concerning the operation programme from 15 July to 15 October 1990 covering 40,000 Afghan refugee families as a positive step towards understanding, trust-building and peace in the country.

The Government of Afghanistan has taken adequate preparations for the voluntary return of the Afghan refugees. These preparations include the reception of the fellow repatriates in the Peace Guest Houses, their transfer to, and resettlement in, residential quarters, their safety and security, restoration of their rights and privileges in accordance with the laws of the country.

The Government requests all the donor countries, institutions and the United Nations specifically, to provide appropriate facilities for the return home of the Afghan refugees and to render their humanitarian assistance, simultaneous with this influx, for their resettlement and rehabilitation of the residential localities.

To the best of its ability, the State of the Republic of Afghanistan helps the return of the refugees in full compliance with the spirit of the Geneva Agreements and in close co-operation with the Office of the United Nations High Commissioner for Refugees (UNHCR) and the Office of the Co-ordinator or the United Nations Humanitarian Assistance to Afghanistan at Kabul.

Afghanistan will surely honour the agreements it has concluded with the UNHCR Office at Kabul. The Republic of Afghanistan once again asks the United Nations and the countries where the Afghan refugees have settled to pave the grounds for the voluntary, systematic and peaceful return of all the Afghan refugees and to give urgent and necessary assistance for their repatriation and resettlement.

It is the desire of the Government that all Afghans come back to the bosom of the homeland with peace of mind as its equally rightful citizens and resume their lives in honour and safety in their own ancestral homeland.



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THE SITUATION IN THE MIDDLE EAST

SECURITY COUNCIL
Forty-fifth year

Letter dated 3 August 1990 from the Chargé d'affaires a.i. of
the Permanent Mission of Madagascar to the United Nations
addressed to the Secretary-General

I have the honour to transmit to you herewith the text of a message dated 3 August 1990 addressed to you by His Excellency Mr. Didier Ratsiraka, the President of the Democratic Republic of Madagascar, concerning the situation between Iraq and Kuwait (see annex).

I should be grateful if you would have this letter and its annex circulated as an official document of the General Assembly, under item 35 of the provisional agenda, and of the Security Council.

(Signed) Noël RAKOTONDRAMBOA
Chargé d'affaires a.i.

* A/45/150 and Corr.1.

ANNEX

Message dated 3 August 1990 from the President of the Democratic
Republic of Madagascar to the Secretary-General of the
United Nations

The Democratic Republic of Madagascar, like all States Members of the United Nations, wishes to express its profound concern at the serious developments affecting the relations of Kuwait and Iraq.

While welcoming the speed and relevance of the resolution adopted by the Security Council on the question, we cannot but condemn, on behalf of the universal principles of international law, the invasion of Kuwait like any infringement of the territorial integrity of a sovereign State, regardless of the reasons cited to justify such an offence.

We thus profoundly regret the lack of respect for the sovereignty of Kuwait on the part of its neighbour, Iraq.

We are all the more alarmed because this recent conflict adds further to the already entangled situation in the region of the Middle East, where cases involving the confiscation of territory and the occupation of parts of territory by States which can in no way justify the right to do so have been deplored.

Accordingly, we believe that it is time for the international community to undertake an overall settlement of the question of the Middle East, which is a source of instability and the denial of the fundamental rights of peoples, who must live there in peace and security.

The United Nations, in our view, now has the necessary means to put an end to the possibilities for invasion, occupation and conflict leading to violations of the sovereignty of States and the rights of the peoples of the Middle East.



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EXTERNAL DEBT CRISIS AND DEVELOPMENT

Note by the Secretary-General

The Secretary-General has the honour to submit to the members of the General Assembly for their consideration the attached report, prepared by his Personal Representative on Debt on the basis of consultations with government leaders of creditor and debtor countries and with heads of financial institutions and banks.

ANNEX

Report of the Personal Representative of the Secretary-General
on Debt, the Honourable Bettino Craxi

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FOREWORD BY THE SECRETARY-GENERAL

On 8 December 1989 I appointed Mr. Bettino Craxi as my Personal Representative on Debt. Mr. Craxi was asked to explore ways and means and propose courses of action to promote the speedy and effective lowering of the debt burden of the almost half of the States Members of the United Nations which have seen their growth and development severely hampered by debt-service burdens.

Mr. Craxi has intensively studied and analysed the complex of issues which constitute the debt problematique. He has furthermore consulted widely with the political and financial leaders of both developed and developing countries as well as with the private financial community. His report, which is now being presented to the General Assembly, contains the conclusions that he has reached as well as specific recommendations for a systematic approach to debt and debt-service relief for different country groupings.

I am extremely grateful to Mr. Craxi for his report and for his unstinting and tireless efforts over the past year.

His report is notable for several reasons. It first of all reaffirms and underlines the seriousness and urgency of the debt crisis, which has in fact progressively deepened. As the report of Mr. Craxi also underscores, the debt crisis is intimately linked with the other major threats facing the international community: war, poverty and the destruction of the environment.

Clearly it is time for action to deal with the continuing debt crisis. Such action must be comprehensive and decisive. The specific recommendations put forward by Mr. Craxi deserve the most serious consideration. They would involve sacrifice and contributions from all those involved. But the future of developing countries and the prospects for renewed growth and expansion of the world economy cannot continue to be held hostage by a debilitating crisis such as the one which has been precipitated by the debt problem.

I thank Mr. Craxi for his report and sincerely hope that the reasoned and balanced approach which he advocates will provide the impetus that is now needed to stimulate action leading to a durable solution of the debt crisis.

SUMMARY AND CONCLUSIONS

The following recommendations take into account existing measures to provide debt relief for developing countries: they include possible extensions of those measures as well as some new proposals. In the final section of the present report the recommendations are set forth as a systemic approach to debt relief for different country groupings.

For many developing countries the debt burden represents a major obstacle to their economic and social growth. Hence, there is a need to continue on the path on which the seven major industrialized countries have embarked in their recent economic summits ^{1/} in order to bring the debt burden of developing countries into line with their capacity to pay and thus to create conditions permitting their renewed growth in the future.

The basic positions taken in the report are the following:

(a) The problem of extricating countries and regions with heavy debt burdens from the debt crisis is of a systemic nature and requires the participation of all creditors, not only banks but also Governments and multilateral institutions;

(b) The Brady Plan ^{2/} should be strengthened and provided with more resources and co-ordinated management from an agency within the international financial institutions, working closely with the regional banks;

(c) Following the decisions of the group of seven major industrialized countries at their Toronto and Paris summits it should be possible to obtain further debt relief as needed, differentiated according to level of development and indebtedness of the various types of debtors. Such alleviation should be achieved through long-term debt rescheduling (40 or 30 years) and greater concessionality on debt service in a measure reflecting the various categories of debtors;

(d) Debt-service should be fully written off only in the case of the poorest countries (the IDA-only group), and only for soft loans under official bilateral assistance programmes;

(e) It should be made possible for countries to pay interest on bilateral debts into trust funds in indexed local currencies, to be used for the financing of development projects for environmental protection and human resources development;

(f) An "intermediate" group of debtor countries, between the poorest and the middle-income countries, should be defined with the view to increasing the degree of concessionality of their debt, applying, as a first measure, the Toronto terms to their rescheduling at reduced interest rates;

(g) There should be a commitment to guarantee an adequate flow of public and private funds to developing countries. The report restates the goal of providing 0.7 per cent of gross domestic product (GDP) as official development assistance: that target was reconfirmed by the Ministerial Council of the Development Assistance Committee (DAC) of the Organisation for Economic Co-operation and Development (OECD) at its ministerial meeting on 14 May 1990;

(h) The case-by-case approach should be maintained. However, a clear distinction should be made between different categories of debt, such as debt arising from concessional aid loans, publicly guaranteed debt, non-guaranteed private debts, and debts to international financial institutions. In this context, the status of those institutions as privileged creditors is important both as a support to their concessional lending and as a framework for overall financial stability;

(i) Developing debtor countries and Eastern European countries should adopt cohesive policies of domestic adjustment in collaboration with the international financial institutions. However, adjustment programmes must be selective and growth-oriented. In addition, they should take into account the needs of the less favoured groups of the population;

(j) Private banks should be encouraged, by means of appropriate incentives and co-ordination, to reduce the interest on private debts. Tax and accounting regulations should be revised to favour those creditor banks which reduce interest and provide new financial flows to developing countries;

(k) Consideration should also be given to an increase of the resources of the international financial institutions to be used to finance operations under the Brady Plan and to an SDR (special drawing right) allocation to be used to enlarge the funds available for debt reduction, interest subsidy and bridging loans;

(l) In those indebted countries endowed with a wide range of industrial assets or natural resources, incentives should be provided for "swap" operations that would set up joint ventures and promote the participation of external capital in privatized public enterprises. Commodity bonds should be given public guarantees. Innovative approaches should be considered, such as the payment of part of debt service in bonds expressed in local currency and indexed on export commodities, with the option of using them to purchase shares and other marketable securities;

(m) A special effort must be made to provide financial backing to the countries of Eastern Europe during their transition to a market economy in order to avert serious social shocks. In debt relief, consideration should be given to innovative financing options and the conversion of debt into shares of privatized companies.

It may be estimated that the additional burden on the government budgets of creditor countries of the concessions on bilateral debt would not exceed 0.1 per cent of GDP. This would mean an increase in their aid budgets from 0.35 to 0.45 per cent of GDP.

Special attention should be given to the extension of the system of regional banks. After the recent establishment of the European Bank for Reconstruction and Development, consideration should be given to the establishment of a bank for the Mediterranean region to provide financial flows for enhancing the resources of relevant countries and also to meet the acute problems of population growth and migration.

I. INTRODUCTION

1. The stability and development of the world community in the coming years face four major threats - war, poverty, debt, and the destruction of the environment.

2. Those issues are closely interrelated. The large debts of many developing countries are in part the outcome of excessive arms purchases and military spending. The defense expenditures of the developing countries increased more than sixfold from 1960 to 1985 as a result of the political and military insecurity in their parts of the world. At the very moment when détente has finally arrived in the relations between the industrial countries of the West and the East, political instability has become more accentuated in many regions of the South.

3. The experience of the 1970s and 1980s shows that domestic and international instability has been greatly exacerbated by the wide fluctuations of commodity prices, above all of oil prices.

4. This is vividly illustrated by the developments in the Persian Gulf area in recent months and by the impact of those events on military deployments, oil prices, interest rates, labour migration, workers' remittances, and financial systems all over the world.

5. Cheap oil, food and raw materials benefited industrial countries greatly in the 1980s, but the exporters of those products had to sell their commodities at lower prices than before, while their imports became more expensive. As a result they could not pay their debts and they could not make the investments needed to overcome poverty. In Africa and Latin America, development stagnated and poverty increased in the last decade.

6. Poverty breeds environmental degradation, both in rural and in urban areas. In the former, the use of fuelwood, which is the main energy supply in many poor regions, leads to desertification and urban destitution provokes decay even where basic infrastructure and services have been provided. The World Bank's recent estimates show that the number of the poor in developing countries is rising faster than that of the population as a whole. Such impoverishment brings political instability. The issues of war, debt, poverty and the destruction of the environment are thus closely related, and facing one of them means facing them all. They are all parts of the same international political agenda for the 1990s.

7. The political and economic developments of recent months should heighten awareness of the frequency and seriousness of local conflicts and their expansion to the international arena.

8. They highlight the glaring need to promote international co-operation to break the perverse spiral of war, poverty, debt, and destruction of the environment. They also point to the need to give priority attention to debt relief and concessional financing to those countries which provide evidence of their respect for human rights, strive for peace and adopt sound reconstruction and development plans.

9. Preliminary estimates indicate that in the immediate future, the prospects for the developing countries as a whole are worsening because of the slowdown in the growth of industrial countries' economies, the increase in interest rates and the rise in the price of oil.

10. Before the Gulf crisis, an improvement was expected in the real growth rate of the GDP of developing countries from 3.2 per cent in 1990 to 4.2 per cent in 1991 because of good crop harvests and sustained expansion in China and India, the largest of the low-income countries. It was expected that many other countries too would benefit from the structural adjustment programmes that they had long pursued.

11. Preliminary estimates of the overall impact of the Gulf crisis now suggest a reduction of at least one half of a percentage point in the growth rate of the industrial market economies. Estimates of the impact of the crisis on developing countries are more tentative, but it must be expected that it will be much more severe. The increase in interest rates and the tightening of world liquidity will hit all developing countries, even those few which produce and export oil. The benefits that a few will reap from the increases in oil prices are greatly overshadowed by the interest rate cost to be born by all indebted countries.

12. In short, the present local conflict will, given its major international ramifications, lead to:

(a) A stagnating or negative growth rate in per capita income for many low-income countries, particularly in Africa;

(b) The emergence of major new debtors among the low-income countries in South Asia, which have hitherto managed to escape severe debt problems;

(c) Accentuated debt burdens for many lower middle-income countries;

(d) Acute balance-of-payment difficulties for the countries of Eastern and Central Europe;

(e) A reduction of the flow of external funds to highly indebted countries that export oil, such as Mexico and Nigeria.

13. In brief, the conflict poses a threat to structural adjustment even in those countries where new policies have been pursued most vigorously. It is likely to produce increased poverty and environmental deterioration.

14. The proposals of this report aim at reducing the untenable debt burden of the developing countries. They are the outcome of consultations with leaders of the industrial and the developing countries, as well as with the international financial community. Their general thrust seeks to lessen that part of the international debt burden which breeds war, poverty and environmental degradation. They are not technical solutions to problems of financial engineering; they are proposals aimed at the solution of central political and social issue of crucial relevance for world development in the 1990s.

II. THE GREAT CHALLENGE

A. The debt crisis and underdevelopment

1. Debt, the rich and the poor

(a) Why the debt problem is of general concern

15. The debt problem does not concern only the developing countries. Notwithstanding the complacent view of it taken in industrialized countries in recent years, its implications have a major impact on them as well.

16. Debt is closely intertwined with war, poverty and environmental degradation. Drug trafficking, immigration from countries with stagnant economies, environmental hazards, trade imbalances, and political instability are all exacerbated by the frustration of development and the debt paralysis of recent years.

17. The disorderly migration from Latin America to the northern hemisphere offers a vivid example of this frustration. Such immigration is often an act of desperation rather than choice. Europe is confronted with similar problems in regard to migration from the African continent. The only alternative to such migration flows lies in development, but there can be no development in those regions unless the debt problem is eased.

18. The drug problem is closely connected with a solution to the problem of the developing countries' debt. In some highly indebted countries, drug cultivation and trafficking are seen as the few potential sources of foreign exchange and remedies for underdevelopment; therefore, they are difficult to eradicate in a situation of general economic decline and frustration. They can and must be fought by providing opportunities for sounder forms of economic growth. Otherwise some countries will continue to resort to drug cultivation. Social and political extremist tendencies are also stimulated by poverty and deprivation.

19. Environmental deterioration is also linked to poverty and debt problems. The desperate search for land to be used for pasture and low-level cultivation, the overcrowding of the large cities in Latin America and Asia, and the lack of fuel - all lead to deforestation and desertification, all are primarily due to economic stagnation and decline.

20. This leads to a pressure on natural resources that cannot be controlled without the means provided by a growing economy. The environmental problems typical of development are almost impossible to solve when the service of external debt claims a large portion of the national resources and an excessive share of tax revenues.

21. The forced flow of exports from countries needing to pay their debts has sometimes led to protectionist pressures as well as to negative repercussions on the multilateral negotiations for the liberalization of world trade.

22. A common concern is also the difficult situation in which the large international financial institutions - the World Bank and the International Monetary Fund (IMF) - find themselves, owing to the debt crisis of the developing countries and the countries of Eastern Europe.

23. Granting new loans to indebted countries without the participation of the majority of creditors would be a source of growing risk for the World Bank. However, limiting its lending only to the fully creditworthy countries would not be acceptable for a Bank willing to play its development role.

24. A similar consideration applies to IMF lending to countries with a debt burden that pushes them below the threshold of survival and threatens their disintegration. In such a situation they often stop their payments and accumulate arrears with IMF and the other official creditors.

25. The recent increase in IMF quotas offers a means to provide new funds to developing countries to ease their debt burdens. This is a positive development, but it is probably not enough in view of the magnitude of the problem. It is necessary to explore the possibility of further increasing the amount of concessional resources that IMF and other multilateral financial institutions can use in debt reduction and servicing. In this context, consideration should be given to the proposal for a special allocation of SDRs to be used to guarantee interest payments on the bonds issued by developing countries in the conversion of their commercial debt.

26. From this overview of the interdependencies relating to the developing countries' debt, it is clear that the problem does not concern the debtor countries alone. It is a global issue, which, if not properly answered through common action, will seriously endanger the welfare of industrialized countries and the existence and the financial stability of the multilateral institutions.

(b) The imbalance between the rich and the poor in the world

27. The debt problem of the developing countries is not a normal problem of relations between creditors and debtors. The one billion people who live in countries suffering from the debt crisis for the most part live in poverty.

28. Almost 70 per cent of world output is produced and consumed by some 15 per cent of world population. Developing countries account for 76 per cent of the global population but produce less than 20 per cent of world income. In 1987, the per capita income in the poorest of them, with a population of 2.8 billion, was \$290, as against \$14,500 in the developed market economies; the poorest of the developing countries had more than one half of the world population and 5.6 per cent of world income.

29. In poor countries in Africa and South America the daily calorie intake was 2,385, while in industrialized countries it was 3,375. Life expectancy was 47 years or less in sub-Saharan Africa; in the rich countries of the West it was 77 years.

30. It is clear that policy decisions (or lack of decisions) in the industrialized countries have a profound impact on developing countries. A telling example of this asymmetric pattern of influence is the spectacular rise of real interest rates during the 1980s, which severely affected the debt crisis of the developing countries.

31. The real long-term interest rate of the seven most industrialized countries never exceeded 4 per cent in the three decades following the Second World War, and it was sometimes negative or close to zero during part of the 1970s when some industrialized countries initially responded with reflationary policies to the 1973 oil increase; as a result, the world-wide money supply expanded rapidly and inflationary pressures stepped up. It was in the first half of the 1980s, macro-economic stabilization based almost exclusively on anti-inflationary monetary policies. Without the support of appropriate fiscal and income policies it caused real interest rates to rise to more than 5 per cent in most industrialized countries.

32. Such an increase was later sustained by the persistence of large budget deficits in several important industrialized countries, the reduction of world savings rates in those countries and the higher yield of investments that accompanied the rising productivity in the OECD countries.

2. Origin of the crisis

(a) Causes of rapid debt growth

33. The external debt of the developing countries has grown rapidly from 1980 to 1990; according to the estimates of the Bretton Woods institutions it has reached the figure of \$1,200 billion. The flow of payments for interests and amortizations has increased from \$90 billion in 1980 to an estimated \$175 billion in 1990.

34. There are several reasons for the build-up of this enormous debt. Further, there are important differences between countries. However, in most cases the external debt was created by developing countries in order to finance government budget deficits and sustain ambitious development programmes.

35. The design and implementation of public investments were often poor. Financial, economic and social profitability of many projects were low, even though they were financed with resources borrowed at high interest rates. There can be little doubt that the selection and implementation of public investments were often poor. In this respect, national institutions bear a heavy responsibility, as they left most of the decision-making process to government bureaucracies that preferred to finance public investments through the creation of public debt.

36. There are indications that investments would have been more profitable if they had been undertaken by enterprises - public or private - with managerial autonomy and budgetary and financial responsibility. Productivity was sometimes low because investments were being made in economic systems that were themselves based on an imitation of collectivist models of bureaucratic planning.

37. Much external debt was also created in order to finance balance-of-payments deficits that were intertwined with the deficits of the public sector. The substantial worsening in the terms of trade of the developing countries' exports, which took place in the 1980s, was also one of the main causes of the deterioration of their debt situation.

38. From a global perspective, the abnormal development of the external debt of the developing countries was possible because of the lack of a set of internationally agreed rules for monetary and fiscal policies and bank supervision. No attempt was made to regulate and to co-ordinate the growing of international public debt. In such a vacuum, borrowing took forms that were especially risky for a developing country.

39. On the creditors' side, during the 1970s commercial banks in developed countries were flush with surplus funds from oil-exporting countries. They were greatly attracted by the terms they could obtain by lending to developing countries, and they were undeterred by the surveillance authorities in their home countries. Lending by commercial banks to sovereign governments in developing countries went beyond any prudent limit.

40. At the time, the increase in the price of raw materials was perceived as a new reality that was there to stay, and not as a cyclical trend. That misconception resulted in irrational behaviour on the part of creditors and debtors alike. Thus, the rises in oil prices of the 1970s led to a great number of international financial initiatives that in retrospect, appear irrational, however sensible they seemed at the time.

41. Extensive guarantees were given to indebted countries by credit insurance agencies in industrialized countries, eager to get profitable contracts for large and medium-sized projects.

42. In the absence of any set of international rules, individual public or private entrepreneurs extended loans without knowing how much others had already lent or intended to lend. As long as the borrowers could borrow against their natural resources, especially oil, old debts could be paid with new loans. But this spiralling could not go on for ever. At a certain point, the bubble burst.

43. When raw material prices fell, the initial belief was that it was a temporary situation. Governments continued to borrow in order to finance their current needs and their balance-of-payments deficits, which retarded the adjustment process and made the debt problem worse. However, at the time, no support came from the industrialized countries.

44. When the United States dollar fell in 1986 and the stock markets crashed in 1987 generous financial shock absorbers were put in place in the industrialized countries. Nothing of the sort was done to meet the consequences of the overlending extended to the developing countries in the 1970s.

45. On the contrary, no consideration was given to the serious repercussions on the situation of the developing countries of the rise in real interest rates. However, responsibilities also lie heavily on the Governments of the developing countries.

46. Many of those Governments had and still have a high level of public spending and low tax revenues. In some countries weak fiscal policies are the product of the vested interests, in others the legacy of past policy mismanagements, and in still others the result of a poor institutional basis. Therapies may differ, but in all of them sound fiscal management should become the prerequisite of any adjustment programme.

47. Finally, it must not be forgotten that high population growth remains a primary long-term cause of the crisis in developing countries. There can be no lasting solution to debt and development problems without policies aimed at controlling the population growth rate.

(b) The crisis

48. With that underlying situation, many developing countries soon entered a state of deep crisis where policy variability greatly increased, giving rise to sequences of devaluations and appreciations in currency exchange rates accompanied by measures of trade liberalization, often reversed with the same haste with which they had been adopted. Government policies lost credibility, and inflationary spirals developed in conjunction with severe declines in GDP growth rates. In most developing countries it became increasingly difficult to service foreign debt.

49. In some others, the debt burden soon reached levels that would suggest the possibility of insolvency and made commercial banks increasingly reluctant to grant new loans. Such reluctance found confirmation in the request by bank supervision authorities to raise provisioning against exposure to developing countries' debt. Further disincentives to lending to those countries came from the rise of a secondary market where claims on developing countries were traded at a severe discount.

50. A high level of provisioning was made necessary and was carried out by the international banking system on the basis of tax and banking regulations that, by and large, encouraged such provisioning but reduced the economic attractiveness of granting either reductions on old loans or new loans. The situation produced a genuine downward spiral, because provisioning acted both as a disincentive towards debt reduction and as a deterrent against new financial flows to developing countries.

51. The massive provisioning by leading banks was evidence of the conviction that debtor countries were no longer able to pay, which put a halt to lending flows towards them and made them even less able to pay. The result was also a fall in secondary market prices for their debts, which further reduced their creditworthiness and their ability to raise new loans.

(c) The decline in GDP growth in indebted countries

52. The growth rates of GDP and of exports for highly indebted countries have been exceptionally low compared to other developing countries and, unlike those other countries, the imports of the highly indebted countries have also fallen.

Table. Growth and investment in developing countries, 1982-1989

(Percentage)

	<u>Highly indebted countries</u>		All other countries without debt crisis
	Medium income	Poor	
GDP growth rate	1.4	0.8	6.4
Percentage of investments on GDP	19.8	13.1	27.5
Export growth rate	4.9	1.1	8.3
Import growth rate	-0.2	-6.8	5.5

Source: International Monetary Fund. All growth rates are in real terms.

53. For many of those countries there is clearly a financial and economic limit to their ability to pay. However, unlike in the case of individual companies, there are no bankruptcy laws for sovereign debtors that would foresee the possibility of new financing taking place after a debt settlement has been agreed with all creditors.

54. Furthermore, single creditors are not interested in granting the debtor country a substantial discount on their share of its debt and fresh loans for a new start. That would increase the debtor's ability to pay on all its debts, including those of other creditors, from which the individual creditor would not benefit. What is beneficial to all creditors is not necessarily so for the individual one.

55. The co-ordination of debtors and creditors, which is ensured by the domestic bankruptcy laws in many countries, will thus not be achieved at the international level without an appropriate set of universally recognized rules.

56. There is clearly a need for an institution or a mechanism that would provide a framework necessary to achieve collective agreements that do not materialize spontaneously. In the establishment of such a framework all actors have to do their part.

B. Debt and recovery

1. Basic parameters

(a) Relationship between debt service, GDP and exports

57. The burden of debt service on national income and exports stems from the massive transfers of resources from domestic consumption and investment to foreign creditors.

58. As the average income level falls and the income distribution becomes more unbalanced, the decline in the resources available to the debtor country becomes increasingly more burdensome.

59. Since most of the debt of developing countries is public or publicly guaranteed, its financing requires raising taxes and cutting spending, or issuing new debt, or transferring the deficit - through inflation - onto the whole economy.

60. The danger of policy mismanagement when debt service accounts for a large share of exports is particularly strong. The need to meet heavy interest obligations will make measures such as import restrictions, credit controls and discriminatory taxation appear attractive. However, such a policy course will have an impact on the standard of living and on investments and will undermine political and social stability as well as the very process of economic growth and employment.

(b) Interest rates and the growth rates of GDP and exports

61. If the problem of indebtedness is to resolve itself spontaneously in the course of time, two conditions must materialize. First, the GDP growth rate of the indebted country, measured in the debtor's currency, must be greater than the interest rate on its debts. If no new debts are contracted, except those deriving from the accumulation of unpaid interest, the debt stock will gradually become an increasingly smaller percentage of the indebted country's GDP. Second, the growth rate of net exports (the export-import balance) should also be higher than the interest rate on the debt.

62. When one considers those two conditions, the reason for the emergence of the debt crisis in the 1980s is clear: real interest rates were indeed much higher than the growth rate of GDP and that of exports in those developing countries now confronted with severe debt problems.

2. General policies to overcome the debt crisis

(a) Sustained growth in GDP and exports

63. The analysis of the debt situation, as well as discussions with government leaders of creditor and debtor countries and with the financial community at large, brought about two main points of consensus. Firstly, the debt problem can be resolved only in a climate of generalized growth, in both debtor and creditor countries. Secondly, there must be increased opportunities for the exports of

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debtor countries, which should also be protected from excessive price variability on the world markets.

(b) Lower interest rates and higher savings rates

64. In the industrialized countries firm monetary, fiscal and income policies will be necessary to neutralize inflationary pressures and to keep interest rates at a low level during the 1990s. This is especially important since recent developments in August and September of this year point to a new rise in interest rates, which would have severe implications for debt and growth.

65. Indebted countries must adopt sound financial and real market economy rules so as to promote savings, to attract domestic and external investments, to increase the return on investments, and to create political and institutional stability. This is essential to secure sustained growth.

66. The principles of self-determination must be respected in the implementation of such changes, which must be based on (a) a reliance, where possible, on market forces, (b) international co-operation, and (c) a gradual application of measures so designed as to avert social shocks that would undermine the growth process.

67. Adjustment policies must not neglect the human cost of sudden price increases and of reductions in social spending. Efforts must be made to protect vulnerable groups against undue deprivation. Adjustment should not be seen in ideological terms but rather as a necessary step to modernization and to a restoration of the economic co-operation between debtor countries and their creditors.

(c) Appropriate tax and accounting rules

68. An essential element of a systemic approach is the review of rules and regulations for tax treatment, accounting and monitoring by banking surveillance agencies so as to promote, rather than hinder, initiatives to reduce the debt of developing countries.

(d) New resources and additional aid

69. The growth policies of developing countries must be supported by donor countries and their development institutions. Official development assistance must be increased towards the target of 0.7 per cent of GDP, which DAC has agreed to be the necessary level for the restoration of growth.

70. Unless debt reduction is coupled with an immediate supply of fresh funds, restoration of the growth process is unlikely. Export credit insurance agencies, regional banks and multilateral institutions have a major responsibility in this regard, for which they will need additional concessional resources.

71. In the end this will test the readiness of the taxpayers in the industrialized countries to support the fight against underdevelopment. It will imply unwavering political commitment, over and above the technical efforts and the financial engineering that are still necessary.

3. Eastern European countries

(a) Debts and investments of Eastern Europe

72. The debts of Eastern European countries (excluding the Union of Soviet Socialist Republics) amounted at the end of 1988 to \$100 billion, of which Poland accounted for 40 per cent and Hungary 20 per cent.

73. Centralized and essentially monopolistic economic planning proved itself incapable of organizing economies efficiently. The absence of the challenge of the open economy was crucial and led to the decline of Czechoslovakia and the former German Democratic Republic, which previously had an important tradition of advanced industries in Eastern Europe, as well as to that of Hungary, which had a solid agricultural tradition and medium-sized industries.

74. That decline occurred despite extensive capital formation; it was due to low and falling productivity. From 1974 to 1984 total factor productivity in the Soviet Union fell by 1.4 per cent a year, while it grew by 1.3 per cent in industrialized countries. Labour productivity grew by a mere 1 per cent, against 2.7 per cent in industrialized countries. The trend in the other Eastern European countries was similar.

(b) Speed and scope of the adjustment process

75. The task is arduous. Medium-term goals are still unclear. Industries have a lot to learn, not so much about basic technologies, but about ensuring quality, tailoring products to market requirements and enhancing the efficiency of production.

76. The partial reforms implemented in some countries in the 1970s and 1980s sometimes made problems worse instead of solving them. They eliminated wage constraints and overall planning rigidity without providing incentives and autonomy for the promotion of efficiency and competition. The effect was a serious surge of inflation.

(c) Risks of excessive flows of new debt

77. It is clear that the financing problem of the Eastern European countries is not only a matter of quantity but above all of quality. Too much financing without selectivity might even increase inefficiency. In the past this was often the case when management of State enterprises, relying on government subsidies and on external debt creation, had few financial constraints and produced widespread inefficiency.

78. In the more recent past, progress towards establishing a market economy has been made in Eastern Europe. Bold steps are being taken in several countries in the areas of prices, exchange rates, and the organization of markets for capital, labour and services, and in the improvement of public finance.

III. THE WAYS OUT

A. Debt reduction strategy

79. Since the early 1980s, the international community has sought ways to solve the debt problem. Three distinct phases of this process can be identified:

(a) Until late 1985, emphasis was placed on market solutions and financial engineering to ease debt restructuring;

(b) From late 1985 to March 1989, the strategy consisted in the provision of financial resources to highly indebted countries with a view to facilitating their growth and structural adjustment and thus reducing their debt burden (the "Baker Plan" after the United States Secretary of the Treasury of the time);

(c) Since 1989, the focus is on debt reduction.

In the following sections, progress under the debt reduction strategy and the specific techniques for reducing the debt burden is reviewed. Comments are made on development finance and regional co-operation and specific suggestions for regional areas and groups of countries are formulated.

B. Debt reduction by private and official creditors

1. The Brady Plan

(a) A bold step in the right direction

80. The Brady Plan emphasizes the need of both a reduction in debts with commercial banks and substantial support by IMF and the World Bank in order to assist in debt and debt service reduction. It recognizes that such reductions can be useful to creditors and debtors alike and can thus be achieved through a voluntary agreement involving all parties. The plan also emphasizes that the indebted countries require new money. Specifically, the Brady Plan is made up of the following components:

(a) Financing from official sources in support of debt and debt service reductions;

(b) Conversion of short-term and medium-term debt into long-term debt and/or into equity;

(c) Debt buy-back;

(d) Overall agreement of debtor country or countries with creditor banks on the basis of credible and feasible adjustment programmes.

81. Despite its positive impact in several cases, experience with the Brady Plan has raised a number of problems related to the long duration of negotiations, the lack of resources and the use of guarantees. There are a number of explanations for the long duration of the negotiations on debt reduction that have taken place in the framework of the Brady Plan. The banks are usually bound by a "sharing" clause, which implies that any one of them - in case of gaining a benefit - has to share it with all other banks. They are also usually bound by a "negative pledge" clause, which precludes the debtor from meeting the obligations stemming from a debt contracted at a later stage before complying with those connected with a previous one. The presence of these clauses and the collusive behaviour of creditor banks have made the negotiations undertaken under the auspices of the Brady Plan excessively lengthy and sometimes less effective than expected. Therefore this new debt strategy needs to be strengthened through the creation of the legal and institutional mechanisms that are necessary to ensure co-ordination from all the parties interested in the debt reduction operations.

82. The financial resources available for the Brady Plan are probably not adequate to bring about sufficiently large debt reductions quickly enough and to stimulate the flow of new financial resources towards the countries that are carrying out economic adjustment programmes.

83. Japan's lead in providing financial means to the Brady Plan should be followed by other countries. As an alternative, the same goal could be reached by using a special issue of SDRs.

84. The limitation of interest guarantees to no more than 18 months greatly curtails the intended enhancement of the bonds issued by debtor countries for debt conversion or buy-back. Stronger guarantees on the interest side would make for greater readiness to consider deeper debt reduction.

85. The difficulties of the Brady Plan relating to co-ordination among the creditor banks and to the availability of resources would be more adequately surmounted if an agency or ad hoc authority within the Bretton Woods institutions were to administer all aspects of debt and debt service reduction operations.

86. Another difficulty of the Brady Plan arises from differences among national systems of taxation, accounting and bank surveillance rules covering loans to developing countries. Some systems (Switzerland, Great Britain, Germany and France) allow a tax deduction for large provisioning on risky loans at the time that such provisioning is built up, while others (Japan, Italy and the United States) do not, or only for very small percentages, while they allow deduction of actual capital losses. Those differences cause distortions and delay negotiations on debt reduction.

87. In most of the countries of the first group, authorities allow no devaluation of claims until they have fallen due without being met. Therefore banks in those countries are usually not interested in voluntary debt reduction operations since they derive no tax benefit from them, and, in all events, their risk has already been covered by their provisions.

88. In countries where tax deduction of losses is allowed but not losses from provisioning (at least not to the full extent), banks have not always had the possibility of building up large provisions; in fact they could not use them to reduce taxable profits and improve their balance sheets. Nor could they spread them over several years. In addition, banks are more interested in reducing the principal of the loan than interest payments because the latter are not recognized as a loss for tax purposes.

89. One way out of the dilemma could be the allowance of wider tax deductions for provisioning, although only as a tax deferral. If, after a certain period of time, provisioning has not been used to back debt restructuring or reduction in ascertained cases of insolvency, the provisioning will then become taxable. That procedure could be applied to tax systems like that of the United States and Japan and now of Italy, which do not (or will not) allow any more provisioning on loans to risky countries.

90. Furthermore, accounting depreciation quotas should be allowed for losses recorded in a fiscal year when such losses stem from operations of overall debt reduction or conversion, as under the Brady Plan.

91. In countries where tax deductions are allowed only for real debt losses, efforts should be made to include deductions of capitalized financial losses due to reductions of interest obligations; that would ensure tax neutrality between the various options of the Brady Plan and improve its viability. Similar steps should be taken for provisioning stemming from the "new money" option under the Brady Plan.

(b) New money and the Brady Plan

92. A major restructuring, with guarantees on the remaining debt, should have a positive effect on country risk and hence on the obligation to build up provisions on new loans. If other debts are converted in addition to bank debts, the result will be an increase in the ability to pay and a lowering of the risk on new issues of bonds and other credits.

93. Providing new money is also an objective of co-financing by the new Expanded Co-financing Operation of the World Bank. That facility is intended both for countries that have not restructured their debt, such as Colombia, and for countries such as Mexico and Chile (and in the future Venezuela and Uruguay) that have completed negotiations under the Brady Plan and have adopted the required economic adjustment programmes.

94. In addition several commercial banks have reiterated their willingness to continue their operations in many developing countries, provided that adequate incentives are put in place. In particular, commercial banks lay special importance on the following incentives: trade-finance and project financing facilities requiring public insurance guarantees on bonds issued against new money and co-financing with the World Bank and with regional development banks.

(c) Strengthening the Brady Plan

95. The Economic Commission for Latin America and the Caribbean has qualified the Brady Plan as unco-ordinated and stated that incentives for banks to forego their claims are not very strong; this produces a tendency to hold back. The Commission declared:

"There is no substitute for a coherent institutional framework that makes each country's offer of debt reduction - within the context of an officially supported adjustment programme - one that most banks cannot refuse. The framework must include incentives for good social behaviours and sanctions for anti-social free-riding. The Brady Plan lacks such a coherent structure". 3/

96. In their joint evaluation of the initial results achieved by the Brady Plan, the World Bank and IMF have acknowledged that so far a lower number of agreements have been finalized than expected. They stated that delays in negotiations should be overcome without jeopardizing adjustment programmes, without increasing the vulnerability of those countries whose debts have been restructured, and without producing an undue transfer of the burden from private to official creditors. The two agencies also affirmed that creditor Governments have not made efforts comparable to those required of commercial banks on official credits to highly indebted medium-income countries, while for the poorest even the Toronto initiative seemed inadequate. Financial resources for debt restructuring should therefore be in addition to those made available by multinational agencies.

97. The World Bank and IMF stated that debtor countries should encourage rather than discourage direct foreign investments, together with specific project financing and trade operations by commercial banks, and also the repatriation of flight capital. This implies the adoption of market-oriented reform measures, including the provision of timely repatriation of dividends, the development of local capital markets, the full protection of domestic courts of law in case of private default, and the elimination of financial repression and unfair taxation practices, together with incentives for the rapid conclusion of negotiations and for the subsequent compliance with the agreed terms.

2. Easing debts to official creditors

(a) The Toronto terms

98. The Toronto terms for rescheduling the debt owed to official creditors by the poorest developing countries were agreed upon by the group of seven major industrialized countries at their Toronto summit in June 1988. They were spelled out in Berlin at the annual meeting of the World Bank and IMF, and then by the Paris Club of official creditors. Under this scheme, all rescheduled concessional debt is to be repaid within a 25-year maturity, including a 14-year grace period. For nonconcessional debt, the creditor countries would choose repayment conditions from among three options:

(a) Partial write-off: To cancel one third of debt service due during the period under renegotiation and reschedule the remainder under standard terms for low-income countries (14-year maturity and 8-year grace at market interest);

(b) Extended maturity: To reschedule the full amount of debt service at market interest but with 25-year maturity and a 14-year grace;

(c) Concessional interest rate: To reschedule the full amount with the maturities of option (a) but at an interest rate 3.5 percentage points below market rates (or one half of market rates, whichever is lowest).

99. This scheme is inadequate. While the Brady Plan calls upon commercial banks to implement substantial debt reductions for all the highly indebted countries, the Toronto agreement only addresses the problems of the poorest among the highly indebted countries, leaving out poor countries with moderate debt levels and highly indebted middle-income and low-income countries.

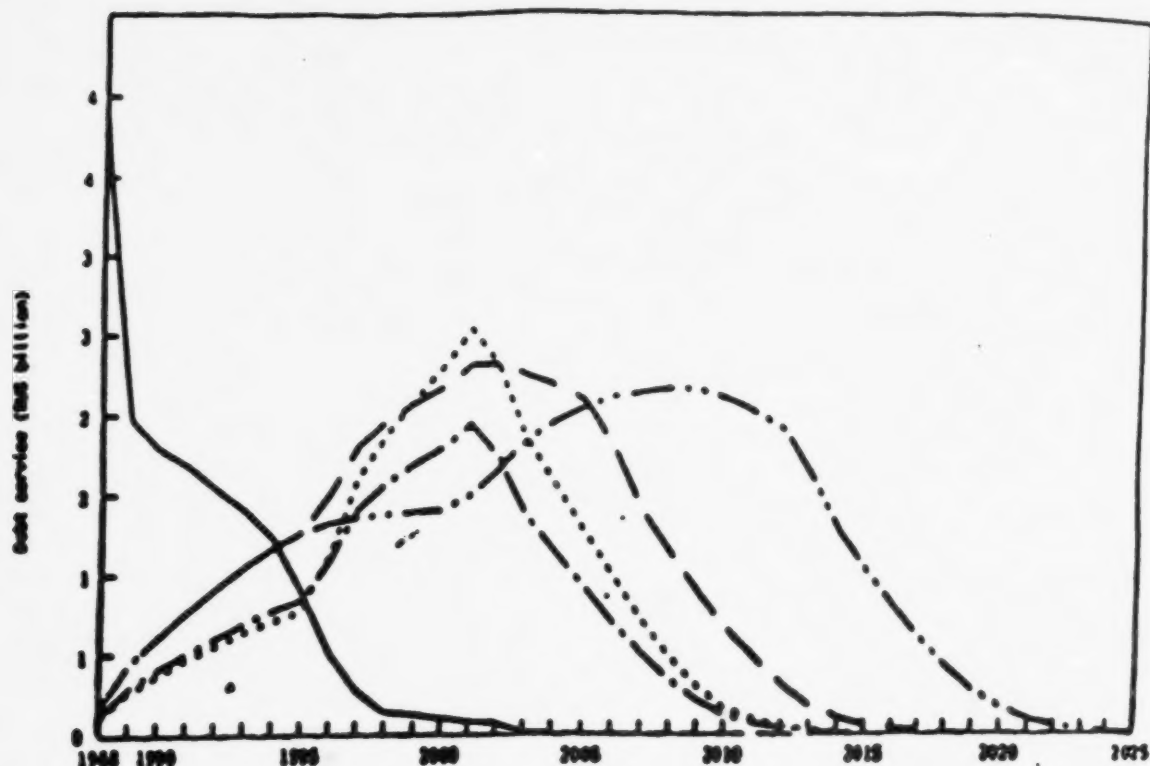
100. For non-concessional debt to Governments, option (a) seems the most logical way to solve the problem of a difficult or impossible payments situation because it includes a reduction of the interest burden by one third. But even this option is weak on two accounts.

101. First of all, the reduction is not great enough for poor countries. Assuming an interest rate of 9 to 10 per cent, a reduction of one-third would reduce interest obligations by some 3 per cent. This, under the Brady Plan, has been found insufficient to help medium-income highly indebted countries out of the crisis and it is a fortiori inadequate for highly indebted poor countries.

102. Furthermore, the extension of maturities produces a concentration of obligations in the future, which makes it difficult ever to get out of the crisis and lays the foundations for further restructuring. The accumulation of future debt burdens prevents low-income indebted countries from obtaining access to commercial credits and investments, thus hampering their return to the market, which is usually regarded as the fundamental objective of adjustment plans. The weak point of all the Toronto options is precisely the growth of the future debt burden, as can be easily seen in the figure below.

Figure. The external debt difficulties of low-income African countries

Debt service - Toronto comparison for 22 countries in the Special Programme of Assistance, 1988-2025



Explanatory notes

- No rescheduling
- - - - - Standard rescheduling
- . - . - Toronto option A
- - - - - Toronto option B
- Toronto option C

Source: Charles Humphrey and John Underwood, "The external debt difficulties of low-income Africa", in Ishrat Husain and Ishac Dwan, eds., Dealing with the Debt Crisis (Washington, D.C., World Bank, 1989).

(b) International Monetary Fund facilities

103. In late 1987, IMF set up the Enhanced Structural Adjustment Facility (ESAF) to help low-income countries with long-standing balance-of-payment problems to adjust their economies and to launch a more effective medium-term process of growth. This programme was supplementary to the Structural Adjustment Facility (SAF) that had been set up in March 1986. Together, the programmes provide \$11.7 billion in 10-year credits at a highly concessional interest rate of 0.5 per cent with five years of grace, almost two thirds by ESAF and one third by SAF.

104. In effect, without this support and without the special interventions of the World Bank already referred to, the picture would be disastrous. But those actions are none the less piecemeal, since they do not face directly the issue of the existing debt burden.

105. Similar considerations apply to the loans of the World Bank. The international financial institutions should get more concessional funds for purposes different from their conventional ones.

106. The issue of relief on debts to IMF and the World Bank and the related question of the arrears to those institutions are not confined to poor countries; they also concern middle-income countries.

C. Techniques for reducing the debt burden

1. Debt conversion methods

(a) Debt-to-equity swaps

107. Debt-to-equity swaps geared to partial privatizations and the relaunching of local companies should be seen in the context of a policy for modernization and genuine liberalization, deregulation, and economic streamlining.

108. It is not only a question of boosting capital inflows in order to meet the immediate problems of the external debt, but rather more of combining debt restructuring with economic adjustment.

109. A survey carried out by the World Bank shows that export companies especially have benefited from investments in debt-to-equity swaps. Foreign investments, at least in joint ventures or in trade partnerships, also facilitate overcoming the trade barriers of industrialized countries.

110. Debt for equity swaps could thus become a stepping stone towards new forms of financial flows to encourage economic initiatives and exports from indebted countries.

(b) Debt-to-debt conversion

111. Among the restructuring operations aimed at debt relief, special attention should be given to those which aim at reducing the burden of variable interest rates. Several loan agreements were entered into when prices of raw materials exported by indebted countries were higher or when real market interest rates were lower than in recent years.

112. However, a simple shift from variable to fixed interest rates may not yield positive results unless the latter are concessional. Restructuring operations carried out in peak periods could lead to fixed interest rates that may subsequently become higher than those at market level. A ceiling on the variable rate could solve the problem: to enhance its potential benefit, the ceiling should be fixed at a highly discounted level.

113. Furthermore, it is worth considering the proposal to link debt service to the prices of raw materials exported by debtor countries. Under such a mechanism, the debtor countries' ability to pay would not be affected by unfavourable fluctuations in their terms of trade in world markets.

114. There are two types of debt conversion that may be advantageous for debtors while involving a low cost for creditors, provided that a sufficient number of creditors join the scheme. The first type involves crediting the interest payments to a special debtor's account, without actual payments taking place and without penalties for delayed payment. The second type would involve payment of at least a portion of the debt service in local currency.

115. The first operation is valid only if the country in question has a real long-term ability to pay and if in each year (with the possible backing of the international financial institutions) it can buy back more of its debt than it accumulates in interest arrears.

116. The second type of debt conversion would foresee total or partial payment of the debt service in local currency indexed to a basket of commodities and expendable for acquiring real assets in the debtor country.

2. Debt buy-back

(a) Debt buy-back must be swift

117. When secondary market prices are low, voluntary buy-back of external debt by debtor countries can be extremely attractive. However, if negotiations for buy-back operations become protracted, the effects can be counterproductive. As institutional debt buyers enter the secondary market, debt prices rise. However, a country deciding to buy back its own debt on the secondary market may be tempted to act in a way that will bring the price down but discourage new money inflows.

118. If an indebted country confronted with payment difficulties applies a de facto moratorium on its debt, this will discourage the inflow of new loans, but it will also depress secondary market prices and consequently make the buy-back of its debt easier.

119. For this reason, buy-backs should be carried out in large blocks with transactions agreed upon once and for all, at a price predetermined on the basis of real indicators, and with a view to a rapid settlement.

120. As in the case of debt-to-equity swaps, buy-backs imply the approval of creditor banks. Free rider attitudes may be adopted by banks waiting for a secondary market price rise resulting from buy-backs carried out on debts with other banks. They may be avoided by predetermining purchasing bids at a fixed level.

121. For this reason too, the best way of carrying out a large scale buy-back is an agreement reached on the basis of agreed indicators and within clear institutional arrangements.

(b) Buy-backs need bilateral or multilateral assistance

122. Buy-backs are almost always public finance operations, since most debts are contracted by Governments and other public finance institutions or by public enterprises guaranteed by the State. In order to buy back its debt a Government can be helped through loans from the international financial institutions.

123. If a country believes that it will soon restore its creditworthiness, buying back its own debt on the secondary market might have negative effects on potential new money flows.

124. However, even in countries that are far from recovering their creditworthiness and from having credible Governments coming to power after political developments of great momentum (e.g., general elections following a return to democracy), the authorities will find themselves confronted with a difficult strategic choice.

125. If they opt for an outright repudiation of their predecessors' debt, they set a negative precedent. It would be wiser for them to show their readiness to buy it back in line with their ability to pay and on the basis of the secondary market value reckoned under the previous Government. If buy-backs are not accompanied by international financing that make global purchases possible, they may end up as more advantageous for the creditors than for the debtor.

126. Assistance from multilateral or bilateral organizations is thus an essential element for the success of those operations in order (a) to provide financial backing, (b) to guarantee the global character of the operation, and (c) to ensure that the buy-back, although taking place over a long period of time, holds to a reference price established at the time of making the overall deal.

3. Summation

127. In summary, in order to expand the scope of debt and debt service reduction the following steps are recommended:

- (a) Increasing the public resources under the Brady Plan so as to raise the degree of debt and/or debt service reduction to 50 per cent;
- (b) Ensuring neutral treatment of the possible options by means of equivalent collateralization (or other guarantees) on the principal, on the interest, and on new money through equivalent tax régimes;
- (c) Providing for partial debt servicing in indexed bills expressed in local currencies and expandable for properties, stocks and goods;
- (d) Reducing the provisioning required for loans to be granted to countries that have concluded debt reduction agreements;
- (e) Setting up an official co-ordinating committee or agency within the international financial institutions with the means to finance or co-finance, in parallel with the interested regional development banks of each area, collaterals, bridging, buy-back, and new money.

D. Development finance, new money and regional common markets

1. Development finance

(a) Transfers between rich and developing countries

128. Until 1983, the developing countries, with the exception of the oil-exporting ones, were borrowing more than they were paying in debt service and thus received substantial net transfers of financial resources from the rest of the world. From then on, however, that flow has been reversed by the loss of new lending. By the late 1980s they were channelling close to \$40 billion a year to the industrialized countries in debt-related transactions.

129. Development aid transfers from industrialized countries, which were of the order of \$30 billion, were thus offset. The overall net result was a negative balance of \$10 billion in terms of actual repayments, and a much higher one in terms of total repayments due.

130. It will be difficult to avoid new problems of external debt if development aid remains at the current low levels. There are acute needs - for additional financing through the World Bank and IMF and through regional banks, for support both of poor countries and middle-income countries with serious debt problems, and for support of those low-income countries which have not incurred such problems, either because of the low level of their spending or their skill in managing their finance problems.

131. On the other hand, it is necessary to accept the principle that help is deserved only by those who actually make the efforts to try to solve their problems, as far as possible, with the resources of their own taxpayers and savers. The phrase "as far as possible" implies respect for those fundamental human rights which are at the basis of civilization as accepted by democratic nations.

132. The adoption of those principles for solving the problems under examination involves raising the GDP share for development aid gradually from the present 0.35 per cent to 0.7 per cent, as DAC has repeatedly urged in its meetings at the ministerial level. With a level of development aid of 0.7 per cent a further amount of \$40 billion would be made available and, if even a small fraction of such an amount were to be used to provide an interest rate subsidy to some developing countries, the scope for additional funds to those countries would be greatly increased. An illustrative projection may be based on the assumption that 0.1 per cent of the GDP in donor countries is likely to approximate \$16.5 billion in 1991. If 1 per cent of that amount were used for interest subsidies, about \$30 billion of additional financing could be mobilized for development.

(b) An international régime for public debt

133. Public debt arising from aggregate budgetary deficits should not be financed with bank loans, as third parties cannot easily assess the complete exposure of the borrowing country. Such debt should take the form of negotiable securities issued internationally under certain limitations; in turn, those limitations should be based on objective indicators in order to avoid the mistakes made in the past. The possibility of earmarking the revenues from specific taxes for debt service purposes must be explored.

134. The case of a country that borrows not for budgetary reasons but to finance specific investment projects is quite different. In that case, it is necessary to consider the financial viability of the project, as well as its social and economic profitability. If the project meets the second criterion but not the first, issuing international debt - even in the form of bonds at market terms - is a doubtful proposition for a country with low tax revenues, even if it has a good exporting capacity.

135. It is then imperative for regional development institutions to assume an active role and to offer concessional terms such as those applied by the International Development Association (IDA) and the Overseas Economic Co-operation Fund of Japan, which have long maturities, low interest rates and long grace periods.

2. New financing

(a) Some innovative tools of new finance

136. The innovative operations of new finance that may be used to channel private funds towards developing countries and Eastern Europe can be classified in two groups: (a) project financing; and (b) commodity financing.

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137. The first group of operations involves the implementation of viable investment projects by entrepreneurs of industrialized countries. The most interesting options are referred to as BTO (build, transfer, operate) and BOO (build, own, operate). Both imply management by foreign entrepreneurs, with the double advantage of exporting technical and managerial know-how and having only one partner.

138. The second group of operations involves financing by foreign investors of specific export operations carried out by enterprises of a developing country.

139. In this respect, the most interesting model is that of merchant banks. In this case, the role of the foreign bank would not be limited to the loan but would also include technical assistance necessary to achieve an exportable product and, above all, international marketing services, so that even small-sized enterprises in developing countries would be able to enter international markets.

140. Commodity bonds are a financial instrument that is particularly apt for the needs of developing countries. They imply reimbursement of the subscribed capital and the payment of dividends during the period of maturity, but their principal and interest are linked to the price of a commodity. Particularly suitable for that purpose would be those raw materials that the debtor country exports.

141. The function of a reference parameter - and, if necessary, of a real guarantee stock - can also be carried out by non-mineral raw materials such as timber or by non-perishable agricultural commodities such as cereals. If effective forms of guarantee can be devised by means of appropriate legal tools and storage facilities, any commodity can be used for these bonds.

(b) Direct investment

142. Direct investment can involve many different forms of co-operation between private and public economic agents in developing countries. The international enterprise may be entirely foreign or partly financed by local entrepreneurs. It could also take a mixed private-public shape, in co-operation with a public enterprise of a developing country or an Eastern European country, or it could be a joint venture between operators of the two geographic areas.

143. If equity with voting rights is entirely foreign-owned at the initial stage, there can be forms of collaboration with domestic entrepreneurs through the issue of bonds convertible into shares.

144. Those financial formulas are also of special interest in encouraging the repatriation of flight capital. Their success, however, depends largely on tax and exchange rate policies. Very delicate issues clearly arise, which must be left to Governments in developing countries to assess. In particular, they have to examine the sensitive taxation problems that may arise.

145. Joint ventures between domestic and foreign entrepreneurs seem highly appropriate in the sector of small- and medium-sized enterprises.

3. New regional common markets

146. The outcome of the Uruguay Round of multilateral trade negotiations is still uncertain. A conclusion less than successful would certainly create strong tensions in trade flows among industrialized countries and between them and developing countries. It is thus vital that the negotiations be concluded with positive and balanced results.

147. At the same time, it seems appropriate to focus on the development of regional common markets, structured in such a way so as to meet local requirements and peculiarities. The recent proposal for a free trade zone comprising the United States and Mexico looks very promising. Other similar projects should be considered.

148. It seems that the time for large regional groupings has come. The debt problems of Latin America, Africa and Asia will find a much easier solution if "new financing" is matched by new areas of free trade between industrialized countries and less developed countries belonging to the same region. The overall objectives of trade groupings, of course, should be to encourage world-wide trade liberalization.

E. Suggestions for regional areas and groups of countries

1. Mediterranean and sub-Saharan Africa

(a) Intermediate countries in Mediterranean Africa

149. The African debt burden - about \$250 billion in all - has two components: that of the countries in Mediterranean Africa (about \$105 billion) and that of the countries of sub-Saharan Africa (about \$145 billion).

150. Mediterranean African countries are officially classified as middle-income countries because their per capita incomes are higher than \$545. They range from slightly less than \$700 for Egypt to \$830 for Morocco, about \$1,200 for Tunisia and \$2,400 for Algeria.

151. Countries such as Egypt, Morocco and Tunisia are classified by the World Bank as "lower middle-income" countries. For debt relief purposes and in supplying new financial resources at concessional terms to improve economic and social growth, the major industrialized countries should recognize this category as distinct from other middle-income countries.

152. That means extending the list of Toronto-eligible countries and adapting that programme to greater requirements. It also implies an ad hoc consideration by IMF and the World Bank of the use of their concessional facilities. It would also call for reconsideration of bilateral development aid policies.

(b) A Mediterranean development bank

153. Debt and development in Mediterranean African countries are a problem of common concern for Europe and Africa. A regional development bank able to operate on the pattern of the Inter-American Development Bank and of the Overseas Economic Co-operation Fund of Japan seems indispensable for channeling towards those countries new financial resources for infrastructural investments and for supporting productive investments by means of insurance guarantees and co-financing.

154. For middle-income countries such as Algeria, the first priority is mainly new finance and more attentive consideration on the part of public insurance agencies and banks in industrialized countries, especially in Europe, of new innovative financing solutions.

(c) Official debt reduction for intermediate countries

155. Additional problems exist in Morocco and Tunisia and, in particular, in Egypt, whose debts have largely been contracted with Governments and international financial institutions. A relatively large portion of Egypt's \$50 billion debt stems from military spending. This is a special case that requires a highly concessional answer.

156. As a general rule, it seems advisable in the case of intermediate countries to allow for a substantial reduction of government and government-guaranteed bilateral debts. In addition, their maturity should be lengthened to 30 years and interest reduced by at most 60 per cent. One fourth of the remainder should be used for environmental initiatives or programmes for human capital, children and growth. Special attention should be given to environmental projects related to the Mediterranean basin and to vocational education programmes for migrant workers.

(d) Adjustment policies

157. It is essential that domestic adjustment policies be pursued with determination. It is vital to improve public revenue and to eliminate and modify the host of corporatist and centralized forms of public and semi-public monopolies in order to achieve a genuine modernization of market structures with a strong emphasis on the needs of the poorest sections of the population.

158. The debt of sub-Saharan African countries has reached \$145 billion. Full payment of interests and amortizations, in the absence of economic growth and expanding exports, would for those countries mean sacrificing their basic needs. The dilemma is whether to cut already low levels of investment or to curb the supply of essential consumer goods, which is already below subsistence levels.

159. During the period 1980-1986, the per capita GDP of sub-Saharan countries fell by 3.1 per cent a year, consumption fell by 2.4 per cent, exports dropped by 2.1 per cent a year in real terms, while imports declined by 7.5 per cent a year, and new investments and maintenance levels were relentlessly reduced. Growth opportunities were also undermined by repeated natural catastrophes.

160. Despite the support of official development assistance (ODA) from all donors, which reached 7.0 per cent of the recipient GDP, there was a dramatic decline in capital formation, with investment falling from 20.2 per cent of GDP in 1980 to 11.4 per cent of GDP in 1984 and only partly recovering to 15.9 per cent of GDP in 1987.

161. Without drastic reductions in their debts, the economic problems of the sub-Saharan countries are unsolvable.

(e) Debt relief for the poorest countries

162. In the wake of the decisions adopted by Italy and France, political, economic and ethical considerations call for a write-off of the debts for the poorest IDA-eligible countries, without affecting other aid flows.

163. As to bilateral credits to non-IDA-eligible poor countries, one step forward would be to convert them into 40-year loans at interest rates as low as 1 per cent. The debt service on these loans would be deposited in trust funds in indexed local currency to finance development projects for environmental protection, such as the safeguard of tropical forests and the struggle against desertification, and the enhancement of human capital. For middle-income countries, reductions should be smaller. Overall, \$3.2 billion of interest could be remitted in this way, while the remaining \$800 million would be added to amortizations and would flow into trust funds.

164. A \$5 billion cut in debt service, composed of \$3.5 billion for State budgets and \$750 million each for banks and multilateral institutions, is not much for rich countries. Yet it can mean survival for the poor and it can open up the road for them to tap vastly greater resources and reach the target of a 6 per cent GDP annual growth rate. This target is feasible and imperative.

2. Latin America and the Caribbean

(a) Financial transfers out of Latin America

165. Latin America is the only developing region that has been transferring resources to rich countries for almost a decade. From the \$10 to 11 billion of net flows into Latin America and the Caribbean of the period 1980-1981, there was a shift to an outflow of \$18 billion in 1982 and \$31 billion in 1983. In 1989, the outflow was \$25 billion. The amount would have been much larger if heavy arrears had not been accumulated.

166. Payments on interests and amortizations from 1982 to 1989 amounted to \$350 billion, which is tantamount to the total export earnings of three years. A debt of \$330 billion in 1982 reached a level of \$435 billion in 1989.

167. The surplus needed to service the external debt was primarily achieved by compressing imports through devaluation, monetary squeezes and cuts in investments and real wages. Except for minor amounts, debt service was usually not financed

through the budget but through the expansion of the money supply, while savings were flying abroad.

168. The average annual rate of inflation in Latin America increased from 57 per cent in December 1981 to 994 per cent in December 1989. It reached 3,000 per cent and more in Argentina, Nicaragua and Peru, while in Brazil was about 1,500 per cent and in Uruguay and Venezuela was about 80 to 90 per cent.

169. The picture was not uniformly bleak since some countries such as Chile and Mexico have managed to control their runaway inflation. Many countries have returned to democracy. Several are now adopting more consistent economic policies and less permissive tax policies than in the past.

(b) Debt and underdevelopment

170. The Latin American and Caribbean countries possess vast natural resources that are not being exploited owing to the debt crisis. Their overall GDP grew by only 1.5 per cent in the 1980s and consequently their per capita income declined by 0.7 per cent a year or by about 10 per cent over the decade.

171. That situation is partly explained by investment compression and the heavy financial drain, but their slow growth cannot be explained only by the loss of capital. Any explanation should also include the deflationary impact of the compression of domestic demand to generate a trade surplus and the disincentives for savings and productive investments stemming from uncertainties in the financial climate and from policy mismanagement. The growth loss has undermined the ability to pay and created the crisis spiral.

(c) A plan for debt reduction

172. The problem of debt and resumption of growth in the countries of the Latin American and Caribbean region should become a permanent item on the agenda of the group of seven most industrialized countries and of the other donor countries.

173. A plan for debt reduction and recycling to help Latin American and the Caribbean countries out of their crisis and to enable them to grow according to their capabilities has to rest on four pillars.

174. First, in the case of official debts of middle-income countries, Governments should apply debt reductions and relief comparable to those accepted by the commercial banks, which would be within the Brady Plan. The scheme must be strengthened by channeling part of the debt service into trust funds where payments would be made in indexed domestic currency and used for projects for environmental protection, children and human capital improvement. This point made in regard to African countries applies to this group of intermediate countries as well.

175. Secondly, special facilities, similar to those adopted for the poorest countries with less concessional terms should be foreseen also for the Latin American and the Caribbean region.

176. Thirdly, a flow of public funds is needed to finance infrastructures at moderately concessional terms and to provide incentives for "new money".

177. Fourthly, the Brady Plan should be refinanced and strengthened. Brazil and Argentina - not to mention Ecuador, Peru and Bolivia, which belong to the intermediate category - cannot find any debt relief in a scheme confined within Mexican terms or based on the proposals negotiated for Venezuela. Incentives to reduce interest payments need to be more effective, and this option must be made as attractive as that of reducing principal. In this context, one should also examine the possibility of having certain countries deposit a share of the debt service in bills expressed in indexed local currency and convertible at par value in local properties. Incentives are needed to speed up the conclusion of the agreements and to make the "new money" option more attractive. Highly concessional financial tools are also needed for buy-back operations; in extreme cases they look like the best solution and in others are useful for widening the options.

(d) All have to do their part

178. Latin American countries also must do their part. Governments have to face up to the unpopularity of new taxes, since their external debt is largely a problem of domestic public deficits. Bureaucrats have to adapt their role to economies in which the private sector has a larger importance than in the past. The wealthy citizens have to invest in their country's future rather than abroad. All must do their part by paying taxes and other dues and by relinquishing populist attitudes.

179. The resumption of growth in Latin America is of interest to the whole world, given the political, economic, social and international equilibriums that are at stake. This is essential if such plagues as drug trafficking and disorderly migrations are to be confronted.

180. After the lost decade of the 1980s, the people of Latin America and the Caribbean are entitled to a decade of hope and progress in the 1990s. With help from other countries and with their own efforts, in a setting of constructive institutional co-operation, it should be possible.

3. Eastern European countries

(a) Two transition strategies

181. Based on the considerations discussed earlier, strategies may be outlined for dealing with the debt problem of the Eastern European countries. First of all, their debt reduction strategies must avoid a repetition of past mistakes.

182. They have to step up the process of rapid and comprehensive transition, relying mainly on commercial finance. Debt with official creditors has to be replaced by debt with private sources of finance and direct investments. Encouragement must be given to innovative options for raising new financial resources, which must be linked to the implementation of investment projects, the exploitation of raw materials and international marketing.

183. Of particular importance is the need to explore the possibility of setting up an Eastern European payments union with the assistance of the financial institutions of the European Communities and to facilitate immediate convertibility, as was done for Western Europe after the Second World War with the assistance of the United States.

(b) The twofold objective of the proposals

184. These suggestions would have two important positive effects. In the first place their implementation would promote the financial and managerial autonomy of enterprises, the flourishing of small- and medium-sized enterprises and the development of a market system. Secondly, it would avoid the building up of new external debt that would give the economy only temporary relief, erode the credit worthiness of countries, and hamper financial flows to productive enterprises.

185. Within the framework of large regional areas, free-trade areas associated with the European Economic Community can be more effective than large government-to-government concessional loans.

F. A systemic approach to debt relief addressed to major country groupings

186. The proposals formulated in this present report can be summarized as follows:

1. New forms of debt forgiveness for the low-income countries (per capita income up to \$545):
 - (a) Total debt write-off of official development assistance for "IDA-only" countries;
 - (b) Conversion of non-concessional bilateral debt into longer-term credits on IDA terms. The service payments of those credits should be channelled into trust funds in indexed local currency for development projects for environmental protection and for enhancing human capital;
 - (c) Increased financial resources of the concessional facilities of the international financial institutions.
2. Reduction of the debt burden for lower middle-income countries (\$545-1,300 per capita income):
 - (a) Conversion of bilateral official loans in 30-year credits, at highly concessional terms and with interest payments utilized to set up trust funds in local currency for the purposes set out in 1 (b) above;
 - (b) Strengthening the Brady Plan for debt to commercial banks by increasing funds to the international financial institutions to ease interest payments and to guarantee equal tax treatment of debt and

debt-service reduction operations. Other complementary measures would be related to "bridging", financing of buy-backs, payment in indexed local currency, tax and accounting improvements for creditor banks committed to debt reductions and "new money". The overall aim ought to be an overall debt reduction burden by 50 per cent;

- (c) Increased concessional lending;
 - (d) Expanding the role of regional banks, especially of their facilities at concessional terms.
3. Debt relief for middle-income countries (\$1,300 to \$6,000 per capita income):
- (a) Conversion of non-concessional bilateral assistance as in 1 (b);
 - (b) Strengthening the Brady Plan, in line with 2 (b);
 - (c) As 2 (c) and (d), but with lower concessionality.
4. Support to Eastern European countries to finance transition:
- (a) Conversion of non-concessional bilateral debt following 1 (b);
 - (b) Application of the Brady Plan in line with 2 (b);
 - (c) Support to multilateral instruments of "new money" ("Group of 24", European Bank for Reconstruction and Development) to support transition market economy and to promote infrastructural investments in key sectors.
5. Application of new finance tools to all countries, with particular reference to BOT and BOO schemes (see para. 123 above) and commodity bonds to be enhanced with public insurance guarantees.

Notes

1/ For the final documents of the Toronto Economic Summit, held at Toronto, Canada, from 19 to 21 June 1988, see A/43/435-S/19974, and for the Economic Declaration of the Summit of the Arch, held in Paris from 14 to 16 July 1989, see A/C.2/44/11.

2/ The Brady Plan was originally proposed by the then United States Secretary of the Treasury, Nicholas Brady, as a means of alleviating the debt burden of developing countries.

3/ Economic Commission for Latin America and the Caribbean, "Options to reduce the debt burden" (LC/G.1605(S.E.23/5)), Santiago, Chile, 1990.
